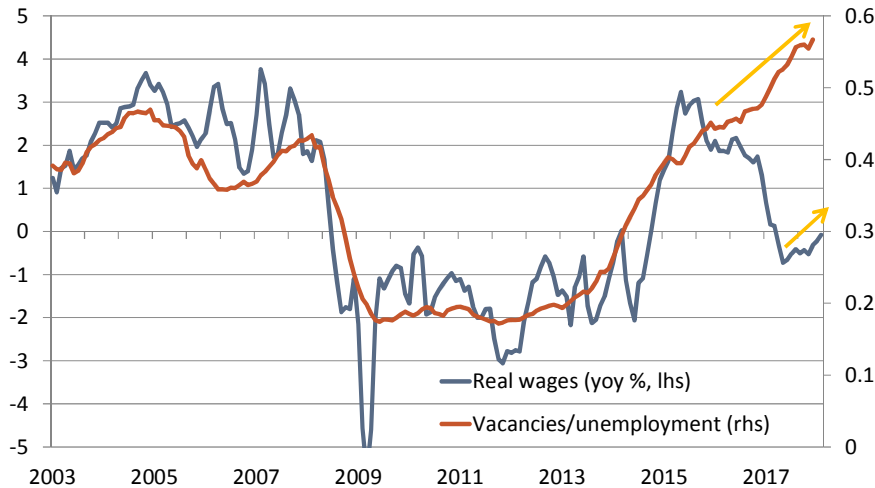


22 March 2018

## BoE outlook: following signals in the labour market

**Tight UK labour market is pushing real wages up again after temporary Brexit-related hit**



Monthly data. Real wages = average weekly earnings including bonuses adjusted by yoy % change in headline CPI. Source: ONS, Berenberg calculations. February wage growth = 2.8% (forecast)

- The fundamental strength:** Thanks to the reforms of PM Margaret Thatcher some 30 years ago, and the good sense of subsequent governments of both stripes not to reverse them, the UK enjoys one of the most dynamic and resilient labour markets in the advanced world. Real wages react quickly to changing conditions in the labour market. During the financial crisis, real wages corrected sharply as unemployment increased. After a time, falling real wages helped labour demand recover and turn the tide on rising unemployment.
- An employment-rich recovery:** The UK has added around 3m jobs during the post-Lehman upswing. Employment is currently at a record high of 32.2m while unemployment, at 4.3%, is at its lowest rate since 1975. With the added boost from falling oil prices, real weekly earnings growth finally started to rise nicely in 2015 in response to tightening labour market conditions after falling for six years. Then came Brexit.
- The Brexit shock:** Real wage growth typically reflects supply and demand conditions in the labour market. The shock Brexit vote in June 2016 temporarily forced a gap in this relationship – see chart. The sharp fall in trade-weighted sterling after the Brexit vote, as market expectations of UK long-term growth fell, caused a temporary jump in import prices and pushed the inflation rate to 3%. Since April 2017, real average weekly earnings have fallen at a rate of about 0.5% yoy as inflation outpaced nominal wage growth.
- Households have managed well since the Brexit vote:** Thanks to robust labour demand and elevated asset and house prices, household confidence has remained firm since the Brexit vote. GfK data shows confidence has averaged -9 since the referendum, just 1pt below the average of -8 since 1974. Real household consumption grew by a firm 1.7% yoy in 2017 despite the real wage hit. As real wages declined, households temporarily increased borrowing and reduced savings to pay for their continuing rise in real consumption.
- The squeeze is over:** Thanks to the drop in headline inflation to 2.7% in February (3.0% in January), and the uptick in nominal weekly earnings to 2.8% in January (up from 1.9% in May 2017), the real wage squeeze is probably over. Tight labour markets should push nominal wage growth higher over the medium term as inflation gradually trends towards a rate of about 2-2.5%. Real weekly earnings growth can rise towards 1.0% by the end of the 2018. Helped by continued jobs growth, this should allow real consumption to grow at close to 1.5% over the medium term.
- Implications for monetary policy:** The sustained strong global backdrop and stable growth at home provides sufficient grounds for the BoE to continue to gradually normalise its monetary policy after hiking for the first time in November 2017. The BoE expects unemployment to remain below its estimate of full employment (4.5% unemployment) with real GDP growth of 1.8% in 2018 and 2019 – well above its 1.5% estimate of potential.
- Policy outlook:** Amid the healthy acceleration in nominal wages and real GDP growth above trend, we upgrade our BoE outlook to four 25bp hikes over the next two years, up from three before, with two hikes in 2018 and now two in 2019 (up from one). This would take the bank rate to 1.5% by the end of 2019. We look for the next 25bp hike in May 2018. With its negative real rate and large balance sheet, the BoE will remain accommodative well into the medium term. The normalisation of monetary policy reflects the improvement in the economy. It poses little threat to it. See [Conundrum: what if bond yields stay too low again](#) for a discussion on global monetary policy.

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